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ABSTRACT

This unit on financing a small business, the eighth in a series of 18 modules, is on the second level of the revised PACE (Program for Acquiring Competence in Entrepreneurship) comprehensive curriculum. Geared to advanced secondary and beginning postsecondary or adult students, the modules provide an opportunity to learn about and try out entrepreneurship ideas so that students can make a preliminary assessment of how these ideas relate to personal needs. The units on this level contain detailed explanations of small business principles, suggestions on how to find information and use techniques, and encouragement for creating a future business. Students completing this unit should be able to perform these competencies: (1) explain how to determine the different types of costs that must be considered when starting a new business, (2) compare the advantages and disadvantages of the various sources of financing for a new business, (3) describe the sources of loans that may be available for financing a new business, (4) describe the information that must be provided in a loan application package, and (5) explain the criteria used by lending institutions to evaluate loan applicants. The unit is organized into five sections. Following a preliminary section on how to use the unit (with vocabulary and a review of the objectives for this topic on level 1), the unit's information is presented in question-and-answer format. Individual and group activities, an assessment to be completed with the teacher, and sources used to develop the unit follow. A list of the modules of Revised PACE, Level 2 completes the unit. (KC)

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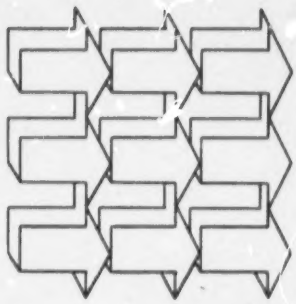
PACE
REVISED
Program for Acquiring Competence in Entrepreneurship



UNIT 8

☐ Level 1
☑ Level 2
☐ Level 3

Financing the Business

Developed by M. Catherine Ashmore and Sandra G. Pritz

You will be able to:

- **Explain how to determine the different types of costs that must be considered when starting a new business.**
- **Compare the advantages and disadvantages of the various sources of financing for a new business.**
- **Describe the sources of loans that may be available for financing a new business.**
- **Describe the information that must be provided in a loan application package.**
- **Explain the criteria used by lending institutions to evaluate loan applicants.**

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Research & Development Series No. 240 BB 8

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BEFORE YOU BEGIN. . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read the Unit Objectives on the front cover. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met at Level 1:

   - Explain the importance of financing in the success of a new business
   - List the different types of costs that must be considered when starting a new business
   - Explain the two major methods of financing a new business
   - Identify the various sources for obtaining financing for a new business
   - List the financial statements that should be included in a business plan

   If you feel unsure about any of these topics, ask your instructor for materials to review them.

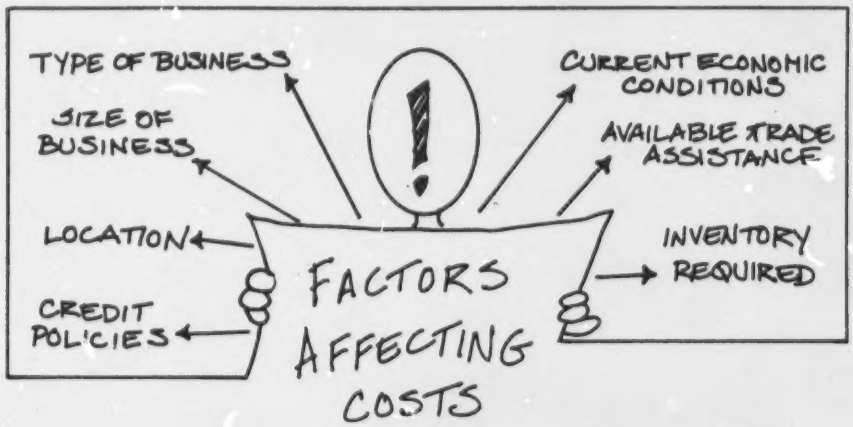
4. Look for these business terms as you read this unit. If you need help with their meanings, turn to the Glossary in the *Resource Guide*.

   covenants
   chattel mortage
   factors
   secured loan

FINANCING THE BUSINESS

WHAT IS THIS UNIT ABOUT?

This unit examines the financing needed to start a new business. Finding adequate financing or the money necessary to get a business started is a roadblock that many aspiring entrepreneurs face. Although the financing barrier may seem insurmountable, it can be overcome. This unit will help you to plan for the financial needs you may have when you open your new business.



The first topic in this unit is determining the different types of costs that must be considered when starting a new business. This topic deals with what you need financing or money to cover. You will also look at the advantages and disadvantages of the sources for financing for the new business.

Since many people need to borrow money to start their businesses, you will look at the various sources of loans that are available. In addition, you will read about procedures for obtaining a loan and the criteria that lenders use to evaluate credit applicants.

WHAT FACTORS AFFECT THE COST OF STARTING A NEW BUSINESS?

Often, prospective entrepreneurs underestimate the amount of money it takes to start a new business and make it prosper. Sometimes this happens because people are swept up in their dreams of owning a successful business. They plunge in without thinking about financing. Other times it may be caused by a lack of knowledge about the amount of money that is really necessary.

Underestimating the amount of financing needed to start a business may seriously hamper its chances for success; overestimating, if it leads to a painfully heavy debt load, may lead to dramatic financing problems, too. This leads to the question "Exactly how much money do I need to start my business?" The answer is "it depends." It depends upon the following factors:

- the type of business
- the size of the business
- the location of the business
- current economic conditions
- available trade assistance
- the nature of the inventory required
- credit policies

The *nature* of the business you wish to start has a great deal to do with the amount of financing needed. Generally, manufacturing businesses require more money to start than wholesale, retail, or service enterprises. The reason for this is that usually manufacturing firms require large and expensive pieces of machinery and larger facilities. More employees may be needed, too. Retail stores may need more financing than service businesses. Normally, the retailer's inventory of merchandise to sell is a large expense. Since service businesses may not need an inventory, they may be started with less money.

The *size* of the business when it is started is another important factor to consider. Large businesses usually take large amounts of money. Small businesses usually do not need as much financing to start. Therefore, it may be smart to start with a small operation and finance its growth through self-generated profits. This should help to avoid taking on too much debt at the very beginning.

The *location* of a business may have a great deal to do with its success. Having a convenient location with ample parking may be a critical factor to the success of a retail business. To bring customers into the store, a retailer may have to locate in a shopping district or

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along a heavily traveled street. Since these locations are very desirable, they are also usually expensive. Store location may be costly for the retailer; small manufacturing and service businesses may not require such expensive locations. The decision on a location may be a difficult one. It usually is not based just on cost. It is wise to think carefully about the part that location plays in the eventual success of a business. (See PACE Unit 7 for more information on selecting a business location.)

When you start a business, it is crucial to remember that you are a part of a very large *economic system*. This system is based upon the interaction of consumers and businesses. You will be dependent upon other businesses and consumers. If current economic conditions are bad, you may face various financing problems. Interest rates may be high, which will make the cost of borrowing very expensive. It frequently takes longer to get a business on its feet during a recession or slump in the economy. Therefore, you may need more money to start your business. If, on the other hand, the economy is healthy and robust, you may not need as much money to start since you may become profitable sooner.

Trade assistance usually refers to suppliers and equipment manufacturers who may help in financing some of the costs of starting a business. If you are starting a retail business, perhaps some of the companies you purchase your inventory from will allow you favorable credit terms instead of requiring cash upon receipt of the merchandise. With the extra time this will give you, you could sell the merchandise to generate the cash you need to pay the bill. Or, suppose you are opening a service operation, such as a quick, one-stop printing business. Maybe some of the manufacturers of the printing equipment you need will allow you to lease it or pay for it over several months. This would make it possible to open your business for less money than if cash were necessary to pay for the equipment fully when it was delivered.

If you start a business that carries an *inventory*, the type of merchandise you handle will affect the costs of starting and operating the business. It usually takes more money to start a furniture store than a clothing store. The main reason, of course, is that furniture inventory costs more than clothing inventory. The selection of items you offer affects costs, too. For example, if your inventory includes all types of mens', womens', and childrens' clothing, it may cost more than an inventory limited to women' shirts/blouses and pants/slacks. Many small businesses start with a limited inventory and then expand as the business becomes profitable.

Will your business be cash-and-carry only, or will you provide *credit* to your customers? This decision will affect the financing necessary to get your business going. Generally, it takes more money to start a business that provides customer credit. This is because it takes longer for you to receive payment, which slows down the amount of cash that flows through your business. Unfortunately too, there will be some bad debts. These losses you will have to absorb.

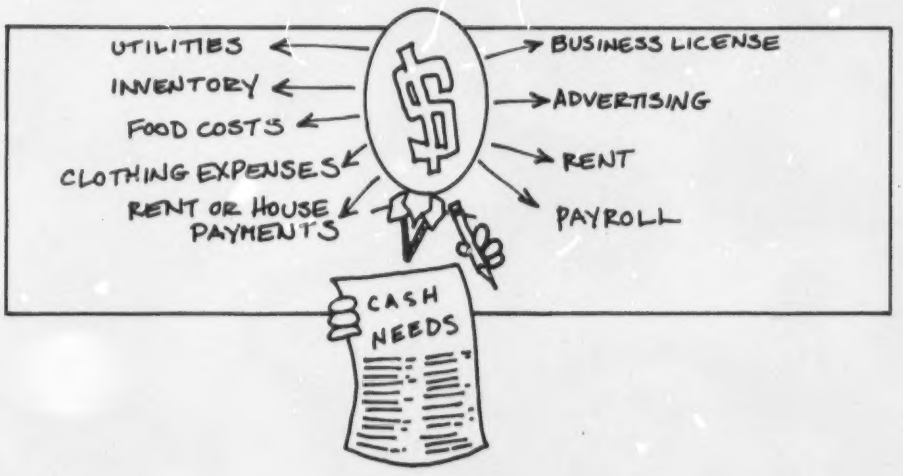
On the other hand, providing customer credit may increase sales in the long run. Many small businesses cannot afford too many credit sales in the beginning.

As you plan the financing of your new business, keep these factors in mind. These considerations apply to most businesses. However, there may be other *special factors* that apply to your situation. Therefore, before you jump to a conclusion about how much financing you will need, think carefully and thoroughly about the factors that will affect it.

HOW DO YOU ESTIMATE YOUR CASH NEEDS?

Now that you are aware of the factors that affect the financing needed to start a business, let's consider the types of costs or expenses you will have and how you can estimate them.

There are basically three types of costs or expenses to finance when starting a new business. *Startup costs* are usually one-time expenses you have only when opening the business. Examples of a these costs would be your business license, your starting inventory, and advertising for your opening. Once your doors are open, you will have monthly *operating expenses*. Since most business are not profitable immediately, it is wise to plan for monthly operating expenses for at least the first year the business is open. Operating expenses include items like monthly rent, utilities, payroll, and inventory. When you are planning the financing of your business, remember your *personal expenses*, too. You will have a rent or house payment, food costs, clothing expenses, and other living costs to pay. If you plan to depend solely upon profits of the business to provide for your personal living expenses, how will you survive if the business doesn't make money?



The biggest and most challenging question is, "How do I determine startup costs, monthly operating expenses, and personal living expenses needed to get my business on its feet? Unfortunately, there is no foolproof, easy, or convenient solution to this problem. Ultimately, the answer will be an estimate based upon your knowledge, experience, and investigation.

It is crucial to gather as much information about financing as you can. Other business owners, including those who have succeeded and those who have failed, could be helpful. The various trade associations or organizations usually have a great deal of data about their particular industry. They may have various "rules of thumb," usually in the form of ratios of different expenses to sales. Once you are able to forecast your expected sales, it is relatively easy to calculate the other expenses using the industrial ratios as a guide. However, because these "rules of thumb" are averages based upon what businesses have done in the past, be careful about using this method exclusively for determining your cash needs. Ideally, the more you investigate the financing of your new business, the more knowledgeable you will become and the more accurate your estimates will be.

Another logical approach is to use a checklist or worksheet that lists the various types of costs and expenses that you may incur. Although there may be various formats available, one that has frequently been used for calculating startup costs and operating expenses is the worksheet presented in a Small Business Administration pamphlet called *Checklist for Going into Business* (Small Marketers' Aid No. 71). A sample of this worksheet is provided for you in figure 1 on the next page.

As you look at the worksheet, you will see that it is broken into two major sections. The top half centers around the monthly operating expenses. The bottom half is concerned with initial startup costs. You'll notice that Column 1 is headed with your estimate of annual sales. This is to help the entrepreneur keep in mind the relationship of sales and expenses. Column 3 assists in determining how many months of operating expenses you need in cash at the time the business is started. It is common to have at least three months of operating expenses in cash prior to starting. However, it may be more or less than three months on any of the individual monthly expenses. Your investigation of the industry and the business will help you decide the number of months to use for figuring this cash reserve. After adding the entries in Column 2, you will have an estimate of the cash needed to start the business.

The worksheet will help you estimate the cash you need to start your business. It is related only to costs and expenses of the business.

WORKSHEET

ESTIMATED MONTHLY EXPENSES			
Item	Your estimate of monthly expenses based on sales of $_____ per year	Your estimate of how much cash you need to start your business (See column 3.)	What to put in column 2 (These figures are typical for one kind of business. You will have to decide how many months to allow for in your business.)
	Column 1	Column 2	Column 3
Salary of owner/manager	$	$	2 times column 1
All other salaries and wages			3 times column 1
Rent			3 times column 1
Advertising			3 times column 1
Delivery expense			3 times column 1
Supplies			3 times column 1
Telephone and telegraph			3 times column 1
Other utilities			3 times column 1
Insurance			Payment required by insurance company
Taxes, including Social Security			4 times column 1
Interest			3 times column 1
Maintenance			3 times column 1
Legal and other professional fees			3 times column 1
Miscellaneous			3 times column 1
STARTING COSTS YOU ONLY HAVE TO PAY ONCE			Leave column 2 blank
Fixtures and equipment			Fill in worksheet 3 on page 12 and put the total here
Decorating and remodeling			Talk it over with a contractor
Installation of fixtures and equipment			Talk to suppliers from who you buy these
Starting inventory			Suppliers will probably help you estimate this
Deposits with public utilities			Find out from utilities companies
Legal and other professional fees			Lawyer, accountant, and so on
Licenses and permits			Find out from city offices what you have to have
Advertising and promotion for opening			Estimate what you'll use
Accounts receivable			What you need to buy more stock until credit customers pay
Cash			For unexpected expenses or losses, special purchases, etc.
Other			Make a separate list and enter total
TOTAL ESTIMATED CASH YOU NEED TO START WITH		$	Add up all the numbers in column 2

Figure 1. Checklist for going into business

SOURCE: Small Business Administration. "Checklist for Going into Business." (Small Marketers' Aid No. 71). Washington, DC: Small Business Administration, 1975.

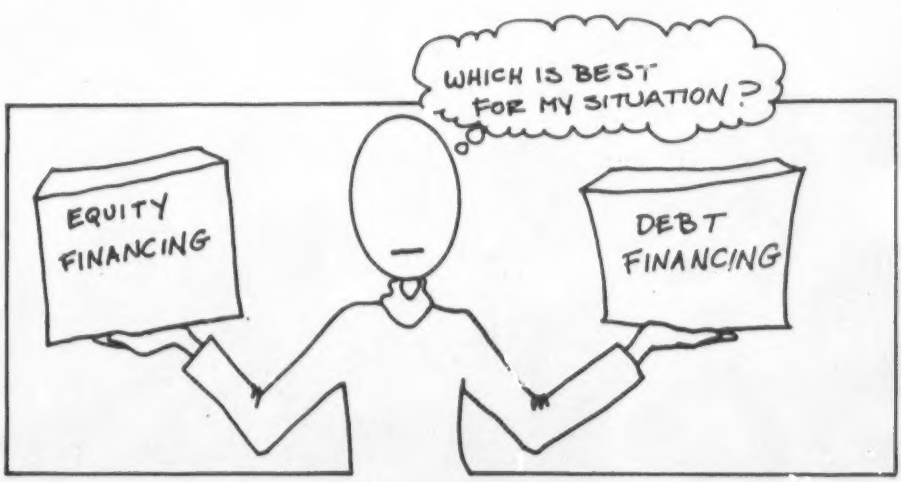
Therefore, you may need another worksheet to figure the cash you will need to cover your living expenses until the business generates sufficient profit for you to pay yourself. The personal living expense worksheet (shown in figure 2) is a guide to calculate how much money you need to live on each month. If you believe it will take four months before the business is profitable enough for you so you can take a paycheck, then four months of living expenses should be added to the total estimated cash needed at the bottom of the worksheet.

Financial advisers suggest that you will feel more comfortable about your first few months in business if you have set aside a minimum of three months' living expenses. Many advisers state that, on the average, businesses take between three and nine months before they can begin to show enough profit to support the personal living expenses of the owners.

WHAT ARE THE SOURCES OF FINANCING FOR A NEW BUSINESS?

Now that you have determined how much money you need to start your business, the next serious question is where to get the money. When prospective entrepreneurs dream of starting their businesses, they usually underestimate the amount of money necessary to get started. When they get serious and systematically calculate the financing needed using the worksheet approach, they may see for the first time how large their cash needs are. To many, this experience is demoralizing. They have a plan and the ambition, but not the money. They frequently ask themselves, "Where will I ever get this much money?"

Usually a combination of various sources is used to come up with the money needed to start a business. Since there are so many potential sources of financing, let's approach them by categories. Basically, there are two categories of financing. One is *equity financing* and the other is *debt financing*. Equity financing consists of money that the owner(s) and others invest in the business. Debt financing involves borrowing money to get the business started. In addition, there are a few other sources of financing that do not fit neatly into either one of the categories.



Based on average month—does not cover purchase of any new items except emergency replacements.

DETAILED BUDGET

Regular Monthly Payments

- Rent or House Payments (including taxes) $_____
- Car Payments (including insurance) _____
- Appliances/TV Payments _____
- Home Improvement Loan Payments _____
- Personal Loan Payments _____
- Health Plan Payments _____
- Life Insurance Premiums _____
- Other Insurance Premiums _____
- Miscellaneous Payments _____

TOTAL $_____

Household Operating Expense

- Telephone _____
- Gas and Electricity _____
- Water _____
- Other Household Expenses, Repairs, Maintenance _____

TOTAL $_____

Food Expense

- Food—At Home _____
- Food—Away From Home _____

TOTAL $_____

Personal Expense

- Clothing, Cleaning, Laundry, Shoe Repair _____
- Drugs _____
- Doctors and Dentists _____
- Education _____
- Dues _____
- Gifts and Contributions _____
- Travel _____
- Newspapers, Magazines, Books _____
- Auto Upkeep, Gas, and Parking _____
- Spending Money, Allowances _____

TOTAL $_____

Figure 2. Personal living expenses worksheet

With such a variety of sources available, it may sound simple to just pick out a few and get the money needed to start your business. However, it is prudent to consider carefully the advantages and disadvantages of each. Also, you may be eligible for some and not for others. Therefore, just as you thoroughly investigated the costs and expenses of starting your business, it is also vital to review the sources of financing carefully. Then you can utilize the ones most advantageous to your situation.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF EQUITY FINANCING?

Equity financing in its simplest form involves the owners' putting their own money into the business. Frequently, a small business is started by one person. The entrepreneur's personal savings that are used are called equity financing. On the other hand, there may be more than one owner. One or more partners may use their money to get started. If a large amount of financing is necessary, the business may be incorporated and shares of ownership in the business sold to many people. Then, too, there are special companies called venture companies that buy partial ownership in promising new businesses for investment purposes. Let's now examine the advantages and disadvantages of each of these sources of equity financing.

Using Personal Savings. Many small businesses are started by one person. This entrepreneur is frequently an independent and self-reliant person. This individual is not interested in sharing the decision making, operation, or ownership of the business. Consequently, the small business owner does not share any of the risks either. Equity financing in this situation consists of the personal savings of the entrepreneur. The advantages of the sole owner using personal savings are—

- all profits are the sole possession of the owner;
- this reduces the amount of money that may have to be borrowed. In turn, this reduces the amount of interest that must be repaid;
- it may provide the entrepreneur with a high degree of motivation and incentive to succeed;
- it shows good faith and confidence on the part of the owner when applying for a loan or other credit arrangements.

The disadvantages of putting one's personal savings into the business include—

- the owner takes the risk of losing what may have taken him or her many years of sacrifice to accumulate;
- it may force the owner to lower his or her style of living or to make even greater sacrifices;
- losing future returns that the personal savings may be earning in some type of interest bearing account or investment.

Involving Family and Friends. Another source of equity financing is using money invested by family members and friends. The main advantage of involving family members and friends is that the money is usually easy and quick to come by. The arrangement, whether it is an investment or a loan, may be somewhat informal. The money is provided on good faith. The entrepreneur may not have pressure exerted from family and friends to meet a certain goal of return on investment or to pay the money back by a specific date.

The central disadvantage is the potential for business problems to destroy personal relationships. If the money is lost or not returned when promised, hurt feelings, guilt, and anger may turn father against son, brother against sister, or friend against friend. Many financial advisers suggest that money from family and friends not be used unless the business relationship is established separate from the social ties.

Forming a Partnership. Two or more persons may form a partnership to start a new business. The formation of a partnership raises questions about who makes the decisions and who is liable for the losses. Arrangements can be made to establish general partners and limited partners. General partners are involved with the day-to-day operations of the business and are liable for the debts of the business. Limited partners are usually not directly involved in operating the business, and their liability is limited to just their investment in the business.

Partnerships may be advantageous because each partner will bring a source of money to the business. Just like the old saying, "Two heads are better than one," two savings accounts are better than one. Also, if each partner's skills complements those of the other, the partners may be more convincing when borrowing money or securing additional investors. On the other side, partners may disagree and have difficulty making decisions. This may interfere with the growth and success of the business.

Incorporating the business. If your new business is in need of a very large amount of cash, forming a corporation and selling shares of stock may be appropriate. In terms of financing the business, this is the corporation's biggest advantage. There are other advantages that deal with legal liability and taxes, too. As with the partnership, the entrepreneur usually loses a certain degree of control and authority when the business is incorporated. Another disadvantage of the corporation is the complexity and costs involved in forming it. Many entrepreneurs are not interested in a legally complicated, long, or expensive process of financing their businesses.

Using Venture Capital. Another form of equity financing is money provided by venture capital businesses. These are private companies that specialize in investing money in new and somewhat risky businesses that have a potential for returning very large profits. Venture capitalists are very selective about the businesses they choose to finance. However, they frequently invest $50,000 to $75,000 in small businesses. Although they may not have limits on dollar

investments, venture capitalists may have minimums. This is because they have certain investment return goals. Some small investments would not return enough dollars to make it worthwhile to them. Many venture capital firms exchange their money for common or preferred stock. As partial owners of the business, they may contribute to major decision making, but they normally do not participate in daily operations.

The advantages of using venture capital financing are—

- these companies usually have lots of money to invest and they are willing to take certain calculated risks;
- the entrepreneur is normally allowed to operate the business independently;
- if the owner needs managerial or additional financial assistance: they may provide it.

The main drawback to venture capital financing is that most small businesses do not qualify. Because many small businesses do not have a large enough dollar return or profit, venture capital operations tend not to be interested. Also, venture capitalists are looking for sophisticated, creative, and high-technology businesses that will grow and expand extraordinarily fast. Again, most small businesses do not fit this pattern.

Working with SBICs. Since many venture capital companies have not been able to meet the financing needs of small businesses, the federal government has decided to help. A law was passed in 1958 that authorized small business investment companies (SBICs). They are private venture capital operations that are eligible for loans from the Small Business Administration. SBICs in turn invest their money in small businesses. A spin-off on the SBIC came about in 1969, when minority enterprise small business investment companies (MESBICs) were also established. The MESBICs specialize in investing in small businesses that are at least 51 percent owned by an ethnic minority entrepreneur.

SBICs and MESBICs are licensed and regulated by the Small Business Administration. They must have at least $500,000 of private capital. Then, for every dollar of their own capital, they may borrow $3 to $4 from the SBA. SBICs and MESBICs may also make loans to small businesses. MESBICs may put up to 30 percent of their private capital in a single business. SBICs are limited to 20 percent. Like other venture capitalist firms, SBICs and MESBICs exchange their money for some type of ownership in the business. Frequently, they take common or preferred stock.

The obvious advantage of the SBICs and the minority enterprise SBICs is they are designed specifically for small businesses, especially those overlooked by many venture capitalists. The other advantages include those previously mentioned for venture capital financing.

Unfortunately, SBICs and MESBICs tend to favor expanding businesses rather than small businesses just getting started. This appears to be their biggest drawback to the aspiring entrepreneur trying to arrange the financing to start a business.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF DEBT FINANCING?

Debt financing means borrowing the money needed to start the business. Like equity financing, there are several available sources, each having its own advantages and disadvantages. Since an upcoming major section of this unit discusses the various sources of borrowing money to start a business, here the discussion will be limited to the advantages and disadvantages that apply to debt financing in general.

Advantages. Borrowing money to start a business may be easier and quicker than using equity capital. Considering that it might take $30,000 to $40,000 to get into business, how many years might it take an entrepreneur to save that much? If you were looking for a partner to share in raising the equity financing, you would be very selective and careful to find just the "right" person. You may be sharing your "dream," and you will be sharing ownership and control. It may take a long time to find this person, and sometimes it is desirable not to find a partner. Some entrepreneurs cannot work successfully with a partner. Borrowing may be the only means of raising the money needed. Fortunately, getting a loan approved is a relatively short process. For example, a bank can usually make a lending decision within a few weeks.

Many loans provide for repaying the money at some later time. This allows the borrower the luxury of using the money now, when it is needed. It can then be paid back when the owner is in a better financial condition to do so.

The owner of a small business may actually be able to save money by borrowing. Although this may sound contradictory, it is true. For example, if you found a real bargain in purchasing inventory, and the amount you saved by buying it now exceeded the cost of borrowing, you would actually come out ahead. Another example might be borrowing the money to buy a piece of equipment that is more

efficient and productive. In the long run, this equipment would save you enough to more than make up the borrowing costs. If your profits will expand at a greater rate by borrowing than they would without borrowing, it makes sense to see a lender.

Another advantage to borrowing is that the interest and other costs are tax deductible as legitimate business expenses. Since these interest expense deductions reduce the amount of tax owed, they are in effect partially offsetting themselves. Hence, the real cost of borrowing is less than the actual dollars paid in interest. Inflation is another factor to consider when considering borrowing costs. During inflationary times, loans are paid back with "cheaper" dollars. The dollars borrowed actually bought more than the dollars will that are being paid back.

Disadvantages. While debt financing has its positive points, it has its drawbacks, too. The most obvious disadvantage is its cost. The prime interest rate is what the biggest, best, and safest business customers pay. Unfortunately, most small businesses do not fit into this category. Therefore, many entrepreneurs are not faced with interest rates several points above the prime rate. Borrowing can be very expensive.

Borrowing can become the habitual stopgap measure that is always the easy answer to cash management problems. Many businesses have failed because more was borrowed than could be repaid. When you take a loan, you are assuming that future profits will allow you to repay the loan with interest. That, of course, is a calculated risk.

Obviously, lenders are careful to insure that loan applicants are good risks. Therefore, entrepreneurs may have to share private and confidential financial and business information. Because of their individualism and pride, many small business owners find this distasteful. However, this is part of the price of borrowing.

Another disadvantage to borrowing, similar to that of divulging private information, is accepting the limitations of the lenders agreement. Most lenders will attach "strings" to the money they loan. That is, the lender will place loan limitations and restrictions on the borrower. The limitations and restrictions are known as covenants. *Negative covenants* set out what the borrower cannot do without prior approval of the lender. An example might be borrowing additional money while increasing the total debt. *Positive covenants*, on the other hand, include what the borrower must do. These usually include maintaining adequate insurance coverage and filing periodic financial statements with the lender. Some entrepreneurs may view these covenants as infringements on the operation of their businesses.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF OTHER FINANCING SOURCES?

If you become involved with a franchised business, you may receive considerable financial assistance. Since it is a form of debt financing or borrowing, the advantages and disadvantages of each correspond. Basically, this means that you must pay back the money borrowed with interest, and must operate the business within the restrictions of the franchisor. In exchange for this, you will be able to arrange the financing of your new business.

Trade credit is similar to debt financing, too. For the most part, it consists of credit that suppliers provide their customers. Inventory and equipment are frequently purchased this way. The advantage, of course, is that you can obtain the inventory you need to generate sales, without actually paying for it. The cash that the sales bring in can then be used to pay the supplier. Trade credit, like other borrowing, implies that interest or some type of fee be paid.

Once a business is started, another way to raise cash is to sell the accounts receivable. Companies specializing in buying another business's accounts receivable are called *factors*. Since factors pay cash for accounts that may not be paid for several weeks or months, they pay less for them than their actual face value. This, of course, is the disadvantage of dealing with factors. Yet selling accounts receivable is a relatively quick and easy way of raising cash without borrowing.

Figure 3 summarizes the advantages and disadvantages of equity and debt financing.

Type of Financing	Advantages	Disadvantages
I. EQUITY FINANCING		
A. Using personal savings	1. Keep all of the profits 2. Reduce amount of debt 3. Risk of loss provides motivation to succeed 4. Shows good faith to any potential lenders	1. Chance of loss 2. May force personal sacrifices 3. Loss of return from use of savings
B. Involving friends and family	1. Easy and quick source of cash 2. Less pressure and restrictions 3. Informal arrangements	1. Risk of destroying personal relationship 2. May encourage unwanted involvement in business
C. Forming a partnership	1. Brings in more cash 2. May be able to borrow more 3. Share financial risks	1. Give up part of profits 2. Give up part of the ownership
D. Incorporating the business	1. Raise large amount of cash 2. Share financial risks 3. Reduce legal liability 4. Tax savings	1. Give up part of profits 2. Give up share of control and ownership
E. Using venture capital	1. Large amounts of money available 2. Money available for calculated risks 3. Maintain control and operation of business 4. Additional assistance usually available	1. Most small businesses don't qualify 2. Must give up part of ownership of the business
F. Working with SBICs	1. Set up specifically to help small businesses 2. Provide loans, too 3. Special assistance for minority businesses 4. Others applicable from venture capital	1. Favor expanding businesses versus starting businesses 2. Others applicable from venture capital
II. DEBT FINANCING (Includes all forms of borrowing)	1. Relatively easy and quick to obtain 2. Maintain control and ownership of the business 3. Repay at more advantageous time 4. May actually be able to save money 5. Interest and other costs are tax deductible 6. Inflation allows repayment in cheaper dollars	1. Interest costs are expensive 2. Risk that future profits will cover repayment 3. Easy to abuse and overuse 4. Must share financial and other confidential information 5. Lender may impose limitations or restrictions on borrower

Figure 3. Advantages and disadvantages of equity and debt financing

WHAT ARE THE DIFFERENT TYPES OF LOANS FOR FINANCING A NEW BUSINESS?

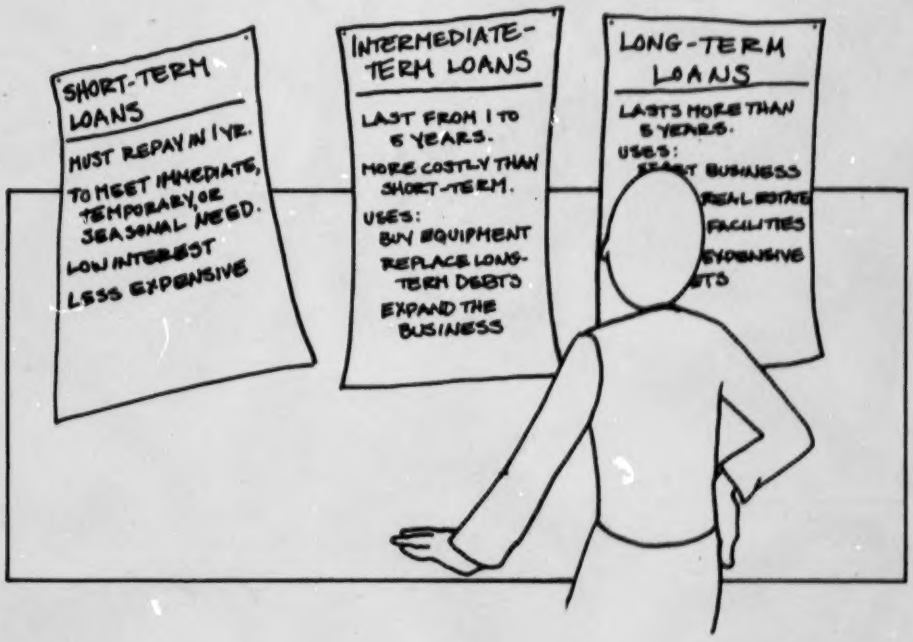
Generally speaking, there are three major types of loans.

Short-term loans must usually be repaid within one year. They are ordinarily made to satisfy some immediate, temporary, or seasonal need. For example, prior to your busy season, you may need additional cash to purchase extra inventory for the increased demand you soon will have. Because the length of the loan is short, the amount of interest that must be paid is small compared to other types of loans. Also, since the risks to the lender may be limited, short-term loans normally are less expensive. Different types of lenders provide different types of short-term loans.

Intermediate-term loans usually last from one to five years. This type of loan may be used to buy new equipment, replace long-term indebtedness, or expand the business. It will be more costly than short-term credit.

Long-term loans normally are set up for more than five years. They are used to get the business started, purchase or construct facilities, buy real estate, or obtain expensive assets that may take several years to pay off. Like the other types of loans, long-term credit is offered by different types of lenders under a variety of terms for assorted purposes.

Let's now take a look at the different types of lenders and the loans they make. Keep in mind that the best source and type of loan depends on the purpose for which the money will be used. It is important to consider the intended purpose of the money, the characteristics of the available financing, and your ability to repay before you commit yourself to borrowing.



Loans are made by both commercial and government lenders. As a general rule, there are more sources of commercial money than government money, but government sources usually charge less than the commercial sources for the use of the money. Each source has its own special loans, credit terms, and pros and cons.

The commercial lenders you will read about include—

- banks
- credit unions
- commercial finance companies
- consumer finance companies
- life insurance companies
- savings and loan associations

The government sources of borrowing presented in this section include—

- the Small Business Administration
- the Economic Development Administration
- the Farmers Home Administration
- the Bureau of Indian Affairs

WHO ARE THE COMMERCIAL LENDERS?

Banks. Conservative by nature, banks make a large number of assorted loans to carefully screened small business operators. Like other commercial lenders, banks must make money by lending money. Therefore, they scrutinize small business borrowers very carefully before agreeing to make them loans. In reviewing small business applicants, bankers are keenly interested in the owner's personal credit history, management skill, and ability to repay. They also consider the financial position of the business, its expected profits, and its chances for growth and success.

The interest rates charged by banks for small business loans are based upon several factors. Banks for the most part do not lend money they actually own. They use the money of depositors and the funds they borrow in the money market. Therefore, the cost of the money they use affects the rate they charge. Short-term loan rates tend to fluctuate, depending upon supply and demand in the market place money market. Therefore, it may pay for the entrepreneur to plan to borrow when the money market rates are lower. A fairly accurate gauge for short-term borrowing is the prime rate. The prime rate is the level of interest that is charged for the most reliable and trustworthy large businesses. Although most small businesses do not qualify for the prime rate, its increase or decrease generally parallels that charged for the more expensive small business loans.

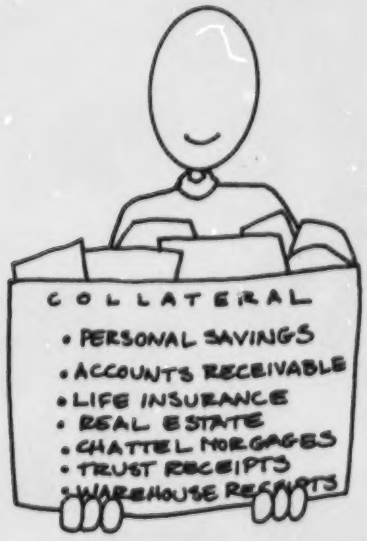
Another factor that affects the cost of borrowing money is the degree of risk that the loan may not be repaid. Time is one variable. The risk of default is greater when there is a long loan period. The stability and strength of the business is another variable. Established businesses with proven credit worthiness are better risks than new and untested small businesses.

Loans to small businesses may be secured or unsecured. A *secured loan* is one in which the borrower has pledged some type of asset that will be forfeited if the money is not repaid. This pledged asset is called *collateral*. It may be any number of items that have value and may be exchanged for money. Frequently used forms of collateral that small businesses use are—

- personal savings
- accounts receivable
- life insurance
- real estate
- chattel mortgages
- trust receipts
- warehouse receipts

Personal savings may be assigned to a bank as security for a loan. Some banks will only lend on a dollar-for-dollar arrangement. This means, for example, if you have $5,000 in savings, the bank will lend you $5,000. This obviously is a very safe loan and it is one that is simple to arrange.

The money that is owed you by your customers may also serve as collateral. These accounts receivable may be paid to you, and you in turn send payment to the bank. Or the accounts could be notified to return their payments directly to the bank. This is another common method that small businesses use to secure loans.



If your life insurance policy builds cash value, you may be able to use it as collateral, too. To do this you must assign the policy's cash value to the bank. If you, the policy holder, were to die prior to the repayment of the loan, the bank would be paid out of the proceeds of the policy before your beneficiary would be paid. Before using the cash value of your insurance policy as collateral on a bank loan, compare the interest rates charged on the proposed bank loan with your insurance company's. Frequently the life insurance company charges a lower rate of interest than banks do, and you would save on the amount of interest that must be paid.

The next two types of collateral are somewhat similar. The real estate or property you own can serve as security for the repayment of a loan. You may assign an interest in the property through a mortgage. The *mortgage* is the legal document that establishes a lien on the property. A *chattel mortgage* is like a real estate mortgage, except the property involved is personal property instead of real property (land or buildings). The personal property that is pledged as security for small business loans is usually some type of large piece of equipment used in the business. A pizza restaurant might, for example, pledge its ovens. If the loan is not repaid, the ovens would be taken by the bank and sold to recover the money that was lent but not repaid.

A *trust receipt* is like a chattel mortgage. It is mainly used by retailers to buy big-ticket merchandise for their inventories. A small appliance store owner may borrow the money to buy televisions, microwave ovens, refrigerators, and other items with a trust receipt. This is the document that identifies the merchandise, usually by a serial number, that you have in stock. When you sell the merchandise, you repay the bank.

You may also borrow money by using your inventory as collateral. The *warehouse receipt* provides evidence that the inventory is stored in your warehouse or in a public one, and that it will be properly supervised. As you sell the merchandise, the loan is repaid to the bank.

An *unsecured loan* is made without putting up collateral. It is frequently called a signature loan. A borrower's excellent credit rating, including previous satisfactory loan experience, may prompt a bank to make a signature or unsecured loan. The amount of money that may be borrowed on an unsecured basis depends upon the credit worthiness of the entrepreneur. However, such loans are usually relatively small.

When a small business has developed a good credit rating and established a positive working relationship with a bank, it may be possible to set up a *line of credit*. This is an ongoing loan that is used, repaid, used, and repaid continually. The small business owner does not reapply each time additional money is needed as long as the credit limit has not been reached. A line of credit is used commonly with inventory financing.

Commercial Finance Companies. Banks, because of their conservative nature, turn down the loan requests of many new small businesses trying to get started. Commercial finance companies are usually willing to take on some of the risks that banks reject. This is because they usually charge higher interest rates and, in a sense, are willing to take a chance to earn a larger profit. As a business that specializes in making commercial loans, the commercial finance company is keenly interested in the quality of the borrower's collateral. Inventory, equipment, and real estate are three forms of collateral most frequently accepted.

Short-term accounts receivable financing and intermediate two-to-five year loans backed by equipment as collateral are the two most commonly used loan arrangements provided by commercial finance companies. However, longer-term mortgages are written for commercial and industrial real estate. To compete with banks, some commercial finance companies make partially unsecured long-term loans of up to ten years. Of course, this type of loan would probably not be available to the entrepreneur looking for money to get the business started. Loans from commercial finance companies normally do not take as much financial information about the business or as much time as bank loans do.

If an entrepreneur cannot obtain a commercial loan, some financial institutions offer personal loans that can be used for starting a business. Credit unions, consumer finance companies, and life insurance companies provide personal loans that can be used for business purposes.

Credit Unions. Although credit unions operate for the personal savings and loan needs of their members, they do make loans that will be used in starting a business. Personal loans may be secured or unsecured, but they are usually short-term or intermediate-term. To obtain a loan you must be a member of the credit union. The entrepreneur should look at the credit union as a limited source of business financing. The credit union might be advantageous for obtaining a small loan with a reasonable interest rate that can be used with other loans and financing to start a business.

Consumer Finance Companies. If you have personal property (like a car, camper, or boat) or real estate (like your house) that you would pledge as collateral, you might be able to borrow money to start your business from a consumer finance company. They may lend you from $30,000 to $50,000 for up to fifteen years if your security warrants it. However, since consumer finance companies usually are willing to take risks that banks and commercial finance companies will not take, they charge higher rates of interest. Besides considering the higher rates when thinking about starting a business with money borrowed from a consumer finance company, contemplate, too, the risk of losing your collateral if you default on the loan. What would you do if you mortgaged your home to the consumer finance company and then the business failed? You might be forced to sell your home or have it taken from you through foreclosure to pay back the loan.

Life Insurance Company Loans. Life insurance policies that build cash values may be used for borrowing money. This is usually a standard part of the life insurance contract. Because the cash value of the insurance policy is based upon cash that the policyholder has already paid in, there is very little risk for the insurance company to assume. Thus, these loans are relatively easy to get and at interest rates substantially below the prime rate. The money may be used for personal or business reasons.

Life insurance companies also make mortgage loans for commercial or industrial real estate. However, these mortgages are usually for very substantial projects that only large businesses would be undertaking. Many small businesses would not qualify for such a loan.

Savings and Loan Associations. Besides making loans so people can buy homes, savings and loan institutions also make commercial and industrial property loans. Savings and loan associations tend to be conservative, like banks. Therefore, associations they will not take uncalculated risks. They will analyze the entrepreneur's personal and business financial situation. Savings and loan associations will usually not make a loan unless the business's profits will be adequate to repay the money.

WHAT ARE THE GOVERNMENT SOURCES OF LOANS?

The Small Business Administration (SBA) was created by Congress in 1953 as a federal agency to serve as this country's advocate for small business. The SBA provides counseling, managerial, and financial assistance. Other federal agencies, including the departments of commerce and agriculture, have or have had programs to assist small business owners financially.

As you begin this section, it is important to keep in mind that the SBA and other governmental loan programs may change periodically. The annual budgeting process may add to and take away from these financial assistance programs. Therefore, for current information you should contact your closest SBA office.

The Small Business Administration defines small business as an independently owned and operated firm that is not dominant in its field. To be eligible for SBA loans, small businesses must meet certain size standards. These vary according to the industry.

The SBA loan program is available to those small businesses that cannot borrow from commercial lenders under reasonable terms. There are two types of basic or regular business loans. Most SBA loans are guaranteed loans. With this type, the SBA guarantees up to 90 percent of the loan that a bank or private lender makes. The other type is the direct loan. In this case, the SBA actually lends the money to the small business. On direct loans the maximum is $150,000. The maximum loan is $500,000 on the guaranteed SBA loans.

Besides its regular loan program, the SBA also sponsors special financial assistance. Some examples of these specific programs follow.

- **Physical Damage Natural Disaster Recovery Loans** may be used to repair or replace damages caused by hurricanes, floods, and other natural disasters.
- **Economic Injury Natural Disaster Loans** may be used for working capital and to pay bills that could have been met had the natural disaster not happened.
- **Small General Contractor Loans** provide short-term financing to small construction businesses.
- **Pollution Control Financing** allows the use of federal tax-exempt industrial revenue bonds to pay for pollution control systems.
- **Economic Opportunity Loans** are available to socially or economically disadvantaged minorities, Vietnam-era veterans, and the physically handicapped.
- **Seasonal Line of Credit Guarantees** provide short-term financing to handle seasonal increases in business.
- **Surety Bonds** guarantee up to 90 percent of losses incurred under bid, payment, or performance bonds issued to small contrators.

The interest rates on SBA loans vary. On the direct loans, the rate is based upon what it costs to borrow money from the government. This is less than commercial interest rates. The interest rate on guaranteed loans is based upon the SBA's borrowing charges.

Other government agencies provide financial assistance to small businesses. The U.S. Department of Commerce provides both guarantees and direct loans to businesses in high-unemployment and low-income areas. The Economic Development Administration handles this program. In the U.S. Department of Agriculture, the Farmer's Home Administration has a guaranteed loan program for businesses in rural areas. The Bureau of Indian Affairs has a loan program to help native Americans start new businesses. Usually, the SBA may help you in identifying the other governmental programs.

To determine whether an entrepreneur is a good risk, any potential lender will want detailed information about the business and its chances of success. The presentation of this information is in a loan application. Because this information is so detailed and may take many pages to present, it is called a loan application package.

WHAT IS A LOAN APPLICATION PACKAGE?

The loan application package is crucial to obtaining the loan. If it is not complete and presented in a businesslike manner, there is a good chance the loan will not be granted. It would be a shame if a worthy entrepreneur had a good idea for a successful venture but could not get the necessary financing just because the loan application was not presented properly.

Before beginning to prepare the loan application package, you should first of all determine what should be included. By talking with potential lenders and the SBA, you can identify exactly what needs to be included. If there are any particular forms that must be completed, you can learn about them, too.

WHAT IS IN THE LOAN APPLICATION PACKAGE?

The SBA suggests that the following information be supplied in a loan application for entrepreneurs starting a new business:

- Describe the type of business you plan to establish.
- Describe your experience and management capabilities.
- Prepare an estimate of how much you or others have to invest in the business and how much you will need to borrow.
- Prepare a current financial statement (balance sheet) listing all personal assets and all liabilities.
- Prepare a detailed projection of earnings for the first year the business will operate.
- List collateral to be offered as security for the loan, indicating your estimate of the present market value of each item.

Generally, the information provided in the loan application package falls into *four categories*. First, information about the business, such as its type, size, location, and financial status, should be included. Second, qualifications of the borrower should be provided. The borrower's educational and experiential qualifications that will help insure the success of the new business, along with a personal financial background, should be a part of the package. Third, the amount of money being requested, its use, and the collateral being put up should be listed, too. Finally, the projected financial position of the business after the first year should be presented. This is usually done in the form of projected profit-and-loss and cash flow statements.

Other items included in the loan application package are at the discretion of the lender. Some lenders will require further information, such as copies of leases, income tax statements, life and casuality insurance policies, ownership papers, and other contracts. Some lenders may want to review your business plan, too.

HOW DO LENDERS EVALUATE LOAN APPLICATIONS?

Now that you have completed the loan application package, the propsective lender must evaluate it to determine whether the loan should be made. The lender's main concern is with getting the loan repaid. Therefore, the lender is interested in the future prospects of your business. Will you be able to survive, grow, and become profitable? Will you be able to repay the loan? This is what the lender must decide.

As the lender considers your loan application, there are usually four areas to review. Net earnings is one of these areas. Will your company generate enough income to sustain the business with enough left over to repay the loan? The immediate and long-range company

outlook is another. Will there continue to be demands for your type of business in both prosperous and depressed times? Looking more broadly, industry outlook is another area to consider. Is your business the part of a growing or dying industry? Will your industry still exist in a few years? The capability of your management is the fourth area. Do you have the managerial skills and motivation to make a success of your business?

Besides reviewing the areas listed above, the lender will evaluate the worthiness of an applicant with more specific criteria. In financial circles, these specific criteria are known as "the six C's."

WHAT ARE THE SIX C's OF CREDIT EVALUATION?

The six C's used for evaluating credit applicants are (1) character, (2) capital, (3) capacity, (4) collateral, (5) circumstances, and (6) coverage.

Character refers to the type of person you are. Some say it is the most important asset of an entrepreneur. Lenders evaluate a person's character according to such traits as honesty, reliability, and trustworthiness. To the lender, a person with strong character will do everything possible to protect the assets and the business, and to insure that the loan will be repaid.

Capital is the amount of money that the entrepreneur has personally put into the business. The personal investment you put into the business shows the lender your faith and commitment in the growth and eventual success of the company.

Capacity relates to the skill and drive of management. A lender is interested in leadership that has clear-cut goals and a detailed plan for seeing the business prosper. An effective management will utilize the loan to assist the business to grow and succeed.

Collateral is the security the borrower puts up to insure that the loan will be repaid. Normally tangible assets—collateral—are forfeited to the lender if the loan is not paid. The better the collateral, the more assured the lender is that the loan will be covered.

Circumstances are other factors that lenders consider that may be beyond the control of the borrower. They must be considered because they may have an effect of the repayment of the loan. The state of the economy, the nature of the borrower's competition, and the nature of the product or service being sold are examples of circumstances reviewed by lenders.

Coverage deals with insurance protection. The lender is interested in the loan being repaid if something unforeseen happens to the owner of the business. Insurance that covers the death of the borrower or losses due to physical damage, liability, or theft help guarantee that the loan will be repaid.

The thorough lender will weigh the applicant's character, capital, capacity, collateral, circumstances, and coverage very carefully before making a loan to any entrepreneur. Knowing this should help you plan your loan application package and interview with the lender.

ACTIVITIES

The following activities are provided so that you can apply what you have learned about financing the business. After completing each exercise, stop and check your answers. This will help you to determine how much you have learned about financing the business.

INDIVIDUAL ACTIVITY

1. Interview an entrepreneur in your community. Ask how the different types of costs were determined to get the business started. Use as discussion points the factors listed in this unit that affect costs. See how many applied to the entrepreneur you interviewed. Ask whether his or her personal expenses were handled by the spouse or if the personal living standard was affected. Ask who provided help in determining the different types of costs incurred to get the business started.

2. In the first column below, write in what kind of equity financing matches the advantages and disadvantages listed in the other two columns. Write the type of financing BESIDE EACH LETTER ON A SEPARATE PIECE OF PAPER.

Type of Equity Financing	Advantage	Disadvantage
A.	Shares financial risks with many others	Must share ownership of the business
B.	Shows good faith on your part to lenders	Loss may force many personal sacrifices
C.	Money available for certain types of calculated risks	Many small businesses don't qualify
D.	Can be set up in an informal arrangement	Risk of destroying personal relationship
E.	Brings in more cash	Share profits with someone else
F.	Special assistance for minority businesses	Favor expanding businesses, not starting new ones

3. On a separate piece of paper, match the different types of commercial lenders in column 1 with their appropriate characteristic in column 2.

1. Bank	A. Essentially borrowing against money you have already paid in

2. Credit union	B. Writes mainly commercial and industrial mortgages
3. Commercial finance company	C. Grants personal loans, usually with high interest rates
4. Consumer finance company	D. May use personal savings as security for loan
5. Life insurance company	E. Commonly uses short-term accounts receivable financing
6. Savings and loan associations	F. Must be a member to qualify for a loan

GROUP ACTIVITY

Divide into small groups of three to four students. For your community, identify the sources available for borrowing money to start a business. This may be done in several ways. The yellow pages of the telephone directory may provide you a listing. Your own bank may know of other sources, too. Newspaper advertisements might give you names. You might see others by just driving through town.

Each person in the group should volunteer to interview one of the sources. See, if it is possible, that a variety of different lenders are included. For example, try to avoid interviewing at three different banks or three commercial finance companies.

Each interviewer should ask the following questions:

- What types of commercial loans do you provide?
- What are the advantages of borrowing money from you?
- What are the disadvantages of borrowing money from you?
- What types of collateral do you accept?
- Do you have any unsecured commercial loans?
- What information do you require in a loan application package?
- What procedures do you use to review the loan applications?
- What criteria do you use to evaluate commercial loan applications?

After the interview has been completed, your group should discuss its findings. Identify the similarities and the differences among the various lenders. Make a list. The small groups in the class should then compare their lists.

CASE STUDY

Jim Perkins, a friend of yours, was recently rejected by a bank for a commercial loan to open a musical instrument store. Jim, who is a music teacher and band director, felt there was a need for a store in your community to sell and rent musical instruments. Lessons could also be provided.

Very discouraged, Jim has called you to discuss the problem. Jim just can't seem to understand why his loan request was denied. He knows that the community needs this type of business and that it would be very successful, if he could just get it started.

As you talk with Jim, the following points come out:

- Jim asked for a $15,000 unsecured loan to open his store.
- The unemployment rate in the community is relatively high.
- Jim had $1,000 saved to put into the business.
- Jim has been a music teacher for the past three years in your community.

Jim says the interview with the commercial loan officer was strange, almost as if they were talking two different languages. Evidently, the loan officer asked him about insurance, projected profit-and-loss statements, and management experience and motivation. Jim told the loan officer about the inventory he wanted to buy and how he planned to organize a community music festival for all his customers.

1. Explain to Jim the six C's used to evaluate commercial loan applications.
2. Evaluate Jim's loan application using the six C's. Point out to Jim his strengths and weaknesses as a commercial loan applicant.
3. Suggest to Jim what he might do to improve his chances of obtaining a loan.
4. Provide Jim with additional sources of borrowing besides the bank.

ASSESSMENT

Directions: Read the following questions about financing the business. These questions are for you to check your knowledge about this topic. When you feel ready, ask your instructor to assess your knowledge on them.

1. Explain how to determine the different types of costs that must be considered when starting a new business.

2. Compare the advantages and disadvantages of the various sources of financing for a new business.

3. Describe the sources of loans that may be available for financing a new business.

4. Describe the information that must be provided in a loan application package.

5. Explain the criteria used by lending institutions to evaluate loan applicants.

SOURCES USED TO DEVELOP THIS UNIT

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Loffel, E.W. *Financing Your Business*. New York: John Wiley & Sons, 1977.

U.S. Small Business Administration, *Business Loans from the SBA*. Washington, DC: U.S. Small Business Administration, Office of Public Communications, September 1980.

Your Business and the SBA. Washington, DC: U.S. Small Business Administration, Office of Public Communications, October 1981.

For further information, consult the list of additional resources in the *Resource Guide*.

Level 2

PACE

Unit 1. Understanding the Nature of Small Business

Unit 2. Determining Your Potential as an Entrepreneur

Unit 3. Developing the Business Plan

Unit 4. Obtaining Technical Assistance

Unit 5. Choosing the Type of Ownership

Unit 6. Planning the Marketing Strategy

Unit 7. Locating the Business

Unit 8. Financing the Business

Unit 9. Dealing with Legal Issues

Unit 10. Complying with Government Regulations

Unit 11. Managing the Business

Unit 12. Managing Human Resources

Unit 13. Promoting the Business

Unit 14. Managing Sales Efforts

Unit 15. Keeping the Business Records

Unit 16. Managing the Finances

Unit 17. Managing Customer Credit and Collections

Unit 18. Protecting the Business

Resource Guide

Instructors' Guide

Units on the above entrepreneurship topics are available at the following three levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business

OSU

The Ohio State University